1812

THE NATIONAL CITY BANK OF NEW YORK

1940

Economic Conditions
Governmental Finance
United States Securities

New York, July, 1940

General Business Conditions

THE events in Europe since May 10, which have culminated in the defeat of France and prepared the way for German attack on Great Britain, are of a nature to stagger the mind and the imagination, so incalculable and far-reaching are their possible consequences. In all countries they have forced governments and business to face new problems, some pressing, and some of such long-term implication that at the moment they can be but dimly comprehended. The decisions called for, some already made, are of incomparable gravity. The spontaneous decision of the United States to arm is one of these. It sets under way a defense program which to be effective must take first place among the interests of the country, and in due course will become the principal influence upon the business situation for an undetermined time.

The trade area is another in which grave decisions in all likelihood will have to be made. The disruption of international trade has become greater than at any time in the last war, and the pattern of trade after the war is a puzzle which only events can solve. Possibility of a German victory and German economic control of Europe has to be considered, and the fear is that totalitarian trade methods will spread. When industries are under state control, and trade is used as an instrument of political policy, export prices may be set without reference to costs, the losses to be absorbed by the state; and the state, moreover, can depress costs by exercising its control over labor, hours and wages for that purpose. No private industry can compete long with subsidized competition unless it also is subsidized. The practical sense of this country shrinks from that kind of trade warfare, and will acquiesce in it only in emergencies and with regret.

Another possibility is that if Germany controls Europe she will make it largely a closed economy, shut out as rapidly as possible the industrial products of the United States, and through barter and clearing agreements compel the countries from which Europe buys its necessary foodstuffs and raw materials to spend the proceeds for European manufactured goods. This would disrupt trade based on three- or four-cornered settlements, such as normally goes on among South America, Europe and the United States.

It should be unnecessary to add that these are but surmises and speculative ideas. The battle of Britain has not even begun. Whether the totalitarian states will obtain the victory of which they seem so confident, and if so whether fears of trade conflict of the character described prove justified, both remain to be seen. Of course such measures would be at the expense of the living standards of Europe, which national policies in the long run have to consider. All experience with barter has shown that it is an inefficient and costly substitute for open trade, since it denies the right to buy in the cheapest and best markets; and efforts toward self-sufficiency require the substitution of high-cost or inferior goods for those which could be produced more economically elsewhere.

The Challenge to Democracy

If events move in the direction feared, this country will have had ample warning. It may still feel confidence in the principle that no state can gain in the long run by running its trade at a loss, and that in the end export trade in competitive markets must belong to the peoples which are most capable and hard working. Both the necessity to rearm and the uncertainty as to trade challenge the efficiency and productivity of the democratic way of life. Both call for the utmost use of all the available technical competence, managerial skill, and labor resources that the country possesses. In none of these respects is the United States inferior to any other country, provided only that it is animated by the same unity and resolve, by co-operation in freeing the national energies that have been dissipated in the waste of the depression, and by willingness to work.

The people who are viewing the prospect with almost hysterical alarm fail to remember that the problem of maintaining a standard of

living against foreign competition has not risen overnight, but is as old as the industrial revoluton. The real danger to this country is the failure to get the domestic situation in order; to resume capital investment, by which the productivity of labor is increased, costs reduced, and goods improved; and to understand that the American standard of living has not been created and cannot be guaranteed by legislative enactment, but is based upon the co-operation of research and engineering, management, capital and labor, to produce more goods at lower unit costs.

Business Trend Upward

The domestic business reports during June have shown little fresh influence of the events abroad. Evidently most of the shock passed off in May, when the impact of events fell upon a public opinion unprepared. Neither the Italian entry into the war nor the French surrender had any pronounced effect, possibly because many French contracts for American products are being assumed by the British, in as orderly fashion as possible; and behind the British the United States Government doubtless stands prepared to take many of them over. Sentiment has steadied, and the security and commodity markets have been firmer, with more attention to the home situation.

Even during May domestic business was in an upswing, led by the steel industry, and since the weather became more seasonable the improvement has extended to some extent to retail trade, particularly in the industrial areas, and to the merchandise industries. Department store sales have been better than usual in comparison with the May figures, and substantially ahead of last year. A buying movement in cotton textiles has supplied the mills with badly needed orders and checked the trend toward curtailment. U. S. Army purchases have stiffened prices for woolen goods, buyers have been operating more confidently, and mill operations have been expanded. Pulp and paper prices are up, and the paper industry is busier than at any time this year.

New orders for steel have equalled or exceeded mill capacity for some weeks, and the operating rate has advanced to 87 per cent with good backlogs in hand. Mills producing steel for France in some cases suspended work on it when the armistice appeal was made; but they have other orders on which to keep going. The improvement in steel began with export orders, which in many quarters are estimated to represent almost 20 per cent of current shipments, but the move spread to domestic consumers, some of whom are stocking steel again for fear of delivery difficulties if export business holds up and defense needs intensify the demand.

Automobile sales have been satisfactory, and production has continued surprisingly high in view of the lateness of the season and heavy dealers' stocks. Probably the Summer curtailment will be heavier than usual.

In terms of the composite indexes which measure productive activity the rise during this period of uncertainty and market unsettlement has been phenomenal, though largely due to the steel improvement alone. The low point in the Federal Reserve index of industrial production (1923-25 = 100) was reached at 102 in April. The May figure was 105 and preliminary data indicate that June may be around 114, with further gains likely in July. This is a level which industrial production has reached, within the past ten years, only during the 1936-37 boom and from October 1939 to January 1940, inclusive.

The Export Situation

Whether the business uptrend will continue will obviously depend in part upon continuance of export trade, and in part upon the speed and extent of defense preparations. After the defense program is fairly under way, and as long as it lasts, it is hardly conceivable that business can be anything but active. But a drop in exports meanwhile, such as would follow interruption of shipments to Great Britain, would be depressing; and no phenomenal expansion of arms output in a few weeks or months should be expected.

Of our European exports, which before the invasion of Scandinavia were running at the rate of almost $2,000,000,000 annually, only our shipments to Great Britain, plus the small amount to Spain and Portugal and a scattering elsewhere, can now be continued. Exports to Britain, increased by a speed-up of munitions shipments and by assumption of French contracts, may rise to a rate approximately $1,000,000,000 a year, compared with $675,000,000 recently; or the increase may appear as larger exports to Canada, representing shipments so routed. But half the European trade which we had during the first quarter has been lost.

South American countries are affected in like manner by the closing of the Continental markets. They sold over $600,000,000 of goods to Continental Europe in 1937 and over $400,000,000 in 1938, and with some exceptions have had a prosperous trade since the outbreak of the war. These exports were more vital to the South American nations than our Continental sales to us. Their decline will reduce South American buying power, and thus affect United States trade. It is axiomatic that this country cannot expect to replace Europe as a seller to South America unless it replaces it as a buyer also.

With all the momentous events of May, total U. S. exports in the month were still 29 per cent higher than a year earlier, and at the highest annual rate since 1929. However, the fact that so much of our trade — possibly as

much as one-fourth of current exports—is now concentrated in one country and largely in war materials suggests the unstable character of the increases. If the war should end, trade in munitions would end with it, and in some lines the effects would be depressing. On the other hand, Continental markets would doubtless be reopened, to some unforeseeable extent, and shipments of foodstuffs, especially from South America, would almost surely be resumed on a large scale.

Problems of Defense Planning

The appropriations and contract authorizations under the defense program, already enacted, have now reached upward of $5,000,000,000, and a $4,000,000,000 navy program is apparently to follow. Of course the expenditures exert an influence long before they are actually disbursed. The sum of the above figures, however, reaches far into the future, and bears little relation to the probable expenditures in any early period.

The task of armament planning and production in the beginning, when the armament industry itself is still to be organized, is almost inconceivably complex. The industries of this country, with only limited exceptions, have been developed for the purpose of supplying not weapons and munitions but the goods and articles used in daily peacetime life. Their factories, machines and tools are designed to make automobiles, textiles, household equipment; and they are specialized in the extreme. To turn out billions of dollars worth of armaments either new plants and new machines must be provided or old ones converted. In either case the job is of appalling complexity and magnitude. The automobile industry is an advanced industry, progressive, experienced, and flexible in management, equipment and methods, but in a recent publication, the National Automobile Chamber of Commerce states that "to switch from producing passenger automobiles to airplanes would in general be accomplished as fast and as well by building new plants as by conversion of existing facilities". It adds that "in many cases this would be equally true of a shift to heavy truck production".

Even when the factory is in existence the make-ready for mass production involves complex and lengthy preparations. Mr. C. F. Kettering of the General Motors Corporation, a great industrial authority, has pointed out that even with the long experience of the automobile industry with annual changes of model, preparations for new models must begin more than a year in advance. This is perhaps a rough measure of the time necessary before certain types of complicated military equipment can be produced on a large scale. Moreover, this does not consider difficulties which may arise in production itself, or such problems as the supply of skilled labor in the places where it is needed, and the ability to get the necessary tools and machines as promptly as the automobile manufacturers are accustomed to get them. This is the "bottleneck" problem, and the effects of every bottleneck spread widely over the field of production.

Experience of the Last War

The experience of the last war shows the slowness with which arms production moves while it is in the preparatory stage, and the speed with which it advances as the difficulties are overcome. In his statistical summary entitled "The War With Germany" (Government Printing Office, 1919) Colonel Leonard P. Ayres, then Chief of the Statistics Branch of the General Staff, published figures of arms production during the World War which are revealing today. When war was declared April 6, 1917, the country was relatively fortunate with regard to rifle manufacture. Several American plants were equipped and producing the Enfield rifle for the British Government, and it was only necessary to modify the design of this rifle to use the same ammunition as the Springfield, a relatively simple change. However, it was not until the last two months of 1917, seven months after the war was declared, that rifle production began to mount in any significant degree. Thereafter the rise was rapid and nearly 3,000,000 rifles were produced within a period of some fifteen months.

At the end of 1917 only 8,000 American machine guns had been produced and not until May of 1918 did the monthly production exceed 10,000. By August the figure was up to 35,000. In artillery, Col. Ayres says, "the difficult problem of planning the production of the different component parts was not satisfactorily solved until about the end of the war." At the end of 1917 only one complete unit of artillery had been made in America. The figure for January, 1918, was 53 and the rise was gradual until the following Summer, when it began to move more steeply to a peak of 420 in October.

The foregoing is not presented as a pessimistic forecast of the speed with which the defense program will go forward, for the nation knows more about the problem than it did twenty-five years ago. But business, labor, Government and the people should understand the difficulties, in order to attack them more resolutely. If public expectations are too high they will be followed by unwarranted disappointment and by unfair judgment of the results. Business men, in determining their own policies, will be ill-advised to jump to hasty conclusions that tremendous demands for industrial materials and products, and an active inflationary movement in prices, are just around the corner. The lesson for labor and manage-

ment is the importance of breaking down, through concentrated effort, the bottlenecks which retard the program in its early stages. The task of the Government is the greatest of all. The function of the Government is to determine what is wanted, provide practicable designs and specifications, and insure that the program is set up in such fashion that the industries can get to work upon it smoothly, efficiently, and also with assurance that they are not taking prohibitive risks in making investments in plant and equipment to fill the orders.

Financing National Defense

The swift passage by Congress last month of measures for expanding our national defense has altered materially but confusedly the financial outlook of the United States Government for the fiscal year beginning July 1. The appropriations for national defense are contained in many separate bills, with amendments, some of which are classed as "regular" and others as "supplemental," "emergency" or "deficiency," in addition to which there are "contract authorizations" to be met from future appropriations. Moreover, although most of the appropriations apply to the current fiscal year, it seems hardly likely that the expansion of the new program can be rapid enough to bring actual disbursement of all available funds by June 30, 1941. In the case of the naval program, particularly, the latest and largest feature — $4,000,000,000 proposed for construction of new ships — is to be spread over a period of six years. For these reasons, the unofficial summaries prepared from press reports and given below are only approximate and tentative.

Increase in Defense Expenditures

Defense appropriation totals, including contract authorizations, which Congress has approved thus far this session are as follows:

National Defense Appropriations and Authorizations for 1941
(In Millions of Dollars)

Regular Army bill	$1,823
Regular Navy bill	1,493
Supplemental defense	1,769
Urgent deficiency	28
Emergency deficiency	252
Strategic materials	12
Total	$5,378

The new 1941 total of $5,378,000,000 compares with budget estimates last January of $1,839,-000,000, and actual expenditures for the 1940 fiscal year (through June 24) of $1,527,000,000. Moreover, it does not include the proposed new naval six-year building program of $4,000,000,-000, nor certain items intended for defense in the Civil Aeronautics Authority, Civilian Conservation Corps, WPA and the Army Civil Functions Supply Bills. Nevertheless, it is $3,500,000,000 larger than the budget estimates and more than three times that of the actual expenditures in the 1940 fiscal year just closed. How much expenditure will fall short of these authorizations no one can now say, but on the other hand still more sums may well be appropriated, as is indeed hinted by Mr. Knudsen's suggestion that additional large orders must be placed to get essential materials into quantity production.

Increase in Taxes for Defense

How are these new costs to be met on top of an already heavy deficit? Fortunately, the Congress has already made a swift and vigorous start on raising part of the funds by taxation. The new tax bill adopted last month is estimated to yield approximately $994,000,000 additional in taxes each year, made up as follows:

Estimated Revenue from New Taxes
(In Millions of Dollars)

Individual income taxes	$375
Corporation income taxes	205
Capital stock and excess profit taxes	12
Estate and gift taxes	32
Alcoholic beverage taxes	125
Tobacco taxes	34
Gasoline and lubricating oil excise taxes	116
Auto, truck, etc. excise taxes	14
Taxes upon admissions to theatres, etc.	60
Other taxes	21
Total Increase	$994

As the increased tax rates will not be fully reflected in the first year of their operation, the increase in revenue for the current fiscal year is estimated at only $715,000,000. The new act may seem like rather a hodge-podge of levies, but in an election year and on short notice it is no inconsiderable achievement. Under such circumstances changes can hardly enter new and controversial fields. The program has at least the two virtues of broadening the tax base and bearing more heavily on luxuries. The only serious question is whether the heavy increases in the higher income brackets will bear down on enterprise, but few complaints are heard as there is general realization that all must make sacrifices at a time like this.

Individual income taxes under the new schedule have the personal exemption lowered from $1,000 to $800 for unmarried persons, and from $2,500 to $2,000 for married persons. This will increase the tax payable by all present taxpayers and will bring an estimated 2,200,000 new taxpayers into the fold. Surtax rates in the brackets from $6,000 to $100,000 are raised. In addition, there is levied a "super tax," amounting to 10 per cent of the income tax as computed under the new law. This will bring the general scale of individual income tax rates to the highest level, and personal exemptions to the lowest, ever in effect in the United States, — not excepting the years during and immediately following the late war.

Corporation normal income tax rates are raised, and a "super tax" of 10 per cent of the income tax is added by the new law.

Other federal taxes which are increased include the taxes on liquor, beer and wine; cigarettes; playing cards; automobiles, trucks, motorcycles, parts and accessories; tires and tubes; oil pipe-lines, gasoline and lubricating oil; electrical energy; radio sets; mechanical refrigerators; toilet preparations; matches; firearms and shells; club dues and initiation fees; admissions to theatres, etc.; telephone, telegraph and radio messages; imports of petroleum, coal, lumber and copper; bond transfers, stock transfers, deeds of conveyance; security issues and insurance policies.

Increase in Deficit and Public Debt

The estimated yield of $715,000,000 from new taxes during the fiscal year 1941, added to the total receipts officially estimated in the January budget, raises the indicated total receipts to $6,866,000,000. This, if realized, would set a new high record for all time in federal receipts, exceeding even those of the previous peak year 1920. With improved business activity, total receipts this year might reach $7,000,000,000. An additional $700,000,000 in Treasury receipts has been proposed through the withdrawal of capital from government credit agencies.

Total expenditures for 1941 were estimated in the budget at $9,027,000,000, including appropriations for the social security old-age reserve but excluding expenditures for debt retirement through the sinking fund. National defense appropriations, as noted above, are some $3,500,000,000 larger than the budget estimates, without allowance for the naval six-year building program. Moreover, since the Emergency Relief Appropriation Act, in authorizing expenditures for WPA of around $1,000,000,000 as estimated in the budget, permits the entire sum to be spent, if necessary, within the next eight months, there is a possibility that a deficiency appropriation of perhaps $500,000,000 for WPA might be called for later.

These possible increases over budget estimates, together amounting to $4,000,000,000, would raise total expenditures for this year to around $13,000,000,000. This may not all be spent this year but again additional defense appropriations are possible.

In the event that revenues of $7,000,000,000 should be realized this year, and expenditures were $13,000,000,000, the net deficit of $6,000,000,000 would be about $3,000,000,000 larger than that indicated in the budget.

This does not all have to be financed by formal offerings of new securities. Social security and other trust funds, charged as expenditures but invested in government securities, have been estimated to absorb about $1,000,000,000 of new issues, and U. S. savings (baby) bonds have been selling at the rate of around $1,000,000,000 annually. These two sources of funds would reduce the amount of new money to be raised in the open market to around $4,000,000,000. The latter figure would be further reduced by any withdrawal of funds from agencies, but such reduction would in effect be offset by whatever open-market borrowing might be necessary by the agencies themselves.

Total outstanding public debt on June 24 amounted to $42,917,000,000, and the budget estimated that by the end of the 1941 fiscal year the total could still be kept within the $45,000,000,000 statutory limitation by a small margin. In order to provide additional leeway for financing the new defense program, however, the upper limit for direct debt has now been raised to $49,000,000,000.

The Program Well Started

The foregoing record of sums voted by Congress for the Army and Navy and provisions for raising the funds makes an impressive showing and merits the commendation of the country. A good beginning has been made on the defense program. At this stage the main thing is to get started along sound lines, avoiding the waste of valuable time in debate over details and controversial matters that can be settled later. Above all, it is necessary to guard against going off half-cocked on untried and ill-considered schemes that may lead up blind alleys, or, worse still, create such disorganization and confusion as to seriously cripple our productive processes.

Now that the first steps have been taken to put the preparedness program in motion, it becomes imperative to give attention to the longer-term aspects of the program. With the debt already so large, and the heavy armament costs looming ahead, questions inevitably arise as to the ultimate effect upon the credit of the Government and the nation's economy in general.

Ways of Meeting Defense Cost

The first—and, it would seem, the most obvious—way of meeting added defense costs is by economies in other forms of government expenditures. This does not mean that relief to the needy should be curtailed. But Congress should carefully scrutinize all items of expense in the light of the new conditions. In public, as in private affairs, many forms of activity appropriate to ordinary times become insupportable in periods of extra and unusual obligations. These should be dispensed with, or at least postponed. The objections made in the past to all moves to curtail government expenses on the ground of aggravating unemployment—always a proposition of questionable validity—now clearly loses force in view of the huge program ahead. Nor does the need for economy stop with the Federal Government. Emphatically, this is no

time to be launching forth on costly state, county and city undertakings which will add to the demands upon taxpayers and compete with the Federal Government in the markets for labor and supplies.

The second way to meet defense costs is through increased taxes. Taxing and cutting down other expenses are the hard ways, and borrowing is the easy way, but we know well that the road of excessive borrowing leads to disaster. Congress has made a wise move in starting the defense program by meeting a substantial part of the cost by taxes. While it would be easy to criticize the bill in detail, it is well to remember, as indicated earlier, that the putting together of any tax bill under pressure involves doing things that are politically practicable and can be done rapidly. The new program has the virtue not only of adding important sums to the revenues, but also of spreading out the cost and making some 2,000,000 more people tax conscious. It is proper also that proposals for drastic increases in taxes and changes in tax methods have been postponed to give time for more adequate consideration.

The third method of meeting defense costs is through borrowing, and it is clear that despite all that may be done in trimming other outlays and in raising taxes, much of the cost will have to be met in this way. In considering this phase of the financing job, two separate types of problems arise.

Financing Plant Expansion

In the first place, there is the question of financing private plant expansion needed to take care of government orders and eliminate "bottlenecks" of inadequate capacity in industry. By and large we all want expansion to go forward and be financed under private auspices, as this will mean less burden on the Government — less deficit, less government bonds to be sold — and will tend to preserve and strengthen the system of private enterprise, which our defense program is meant to protect. Bankers, through their state and national organizations, as well as individually, have given expression of their ability and desire to co-operate fully in the government's program, and high government officials have endorsed the view that requirements be taken care of so far as possible through the regular banking and investment channels.

At a press conference last month, Jesse H. Jones, Federal Loan Administrator, stated that while government agencies may be called upon for loans for plant expansion and equipment, "I can see no reason why most of the capital should not come from the banks," adding that "the banks are all full of money and looking for loans." Both Secretary Morgenthau and President Harrison of the Federal Reserve Bank of New York have likewise emphasized the need to resort to private capital in the first instance, while the attitude of the Securities and Exchange Commission may be summed up in the assurance by its chairman, Jerome N. Frank, to Francis A. Bonner, chairman of the National Association of Securities Dealers, that "the commission will do everything in its power to see to it that no obstacles are placed in the way of raising these funds through the normal financial channels."

In looking to private capital to finance and carry forward an expansion program, it is, however, of prime importance that in the levying of taxes and in the terms upon which government contracts are placed, adequate allowance be made for enough profits to overcome the risk of loss. Otherwise business would be held back from going full steam ahead, and banks, and even the Government, would incur unjustified and unnecessary risks in financing such undertakings.

Everybody would agree that neither business nor individuals should make large profits out of the national defense program. On the other hand, business men are greatly concerned about the action of Congress in reducing maximum allowable profits on government contracts to 8 and 7 per cent from 12 per cent in the case of airplane contracts, and from 10 per cent in the case of shipbuilding contracts. If manufacturers were sure of making these profits and no losses there would be little complaint, but there are bound to be losses. Moreover, whether a profit is real or simply on paper depends upon how it is computed, — whether it is a real net profit after providing for necessary rapid depreciation of tools and plant, whether taxes, interest and development costs, etc., are really admitted as expenses.

It must be remembered that in the last war many business men found themselves at the conclusion of their labors with large losses rather than profits; that many others found a paper profit completely tied up in plant and materials quite unusable and practically worthless in peace times, and others again waited for five, ten or even twenty years, and waded through endless litigation and negotiation before receiving sums justly due from the Government. At the same time they were publicly vilified as war profiteers. Business men naturally want to see their way through these possible difficulties before they can in fairness to their stockholders embark on programs of expansion. And similarly banks and investors who finance the armament program need assurances on these points. Both business men and bankers are eager to participate and are not expecting large profits. They do want to protect themselves against losses.

Questions of Treasury Financing

As to the second part of the problem of defense financing — the financing of the needs

of the Government itself — the main consideration, as stated here a month ago, is that it be carried out in the regular channels and in an atmosphere of confidence. There is no need to resort to unusual methods, such as expenditure of part of the stabilization fund, utilization of Treasury "profits" on silver, and the like, as occasionally suggested; and Secretary Morgenthau has performed a public service in denouncing such "trick" devices. The fact is that there is plenty of money available in the regular sources — the banks, insurance companies and other investing institutions, together with individual investors, to take care of all Treasury needs and at reasonable rates.

Another consideration is how much of the defense financing should go to the banks and how much to other investors. Taking account of the desirability of financing defense expenditures so far as possible by taxation and borrowing from savings, it would seem unfortunate if the additional security issues should be limited to short-term notes, which, experience demonstrates, appeal particularly to banks. While the inflationary effects of financing at the banks are not serious at present, when we still have unemployment and unused productive capacity, they could easily become so if such methods are continued after the economic system has attained full operation.

Money and Banking

The intensification of the conflict in Europe has continued to spur the movement of gold to this country. Following $435,000,000 of gold received in May, some $750,000,000 was received during the first three weeks in June, making the last month's influx surpass all previous records. For the first six months of 1940, the total aggregated almost $2,350,000,000.

Most of the gold coming in June was received by way of Canada and was presumably of British, French, Dutch and Belgian origin. A substantial part of this gold is still owned by foreign central banks, as indicated by the rise of the gold held under earmark at the Federal Reserve Banks from $1,270,000,000 to nearly $1,700,000,000 on June 19. The United States monetary stock also rose sharply, reaching $19,871,000,000 on the 26th, having passed the $19 billion mark only a month earlier, and the $18 billion mark in February.

The further rise in member bank excess reserves to $6,800,000,000 as a result of the heavy gold imports added basic strength to the high grade bond market and interest rates continued to rule at their prevailing low level. United States Government bonds fluctuated only moderately, despite the war news, and worked somewhat higher, so that most issues now are within 2 or 3 points of their all-time high prices.

Trading in government and high grade municipal and corporate issues last month was not particularly active, and there was little evidence of liquidation on the part of the banks, insurance companies and other institutions which make up a major share of the market. On the contrary, certain issues were difficult to purchase in quantity, owing to the large supply of funds available for investment, the scarcity of offerings and the postponement of new security underwritings pending more normal conditions.

Treasury financing during the month was limited to an exchange offer of new 3¼ year 1 per cent notes maturing September 15, 1943, to retire the $352,993,450 of 3⅜ per cent bonds called for redemption June 15, and to the usual weekly refunding of 90-day bills.

Statements of the weekly reporting member banks showed a further rise in deposits during the first half of June, then a temporary decline when the quarterly income tax payments were made into the Reserve Banks for Treasury account. As these government funds are later disbursed, they will of course be reflected again in member bank deposits.

Changes in bank loans during the first three weeks of June were relatively small, except for a further decline in brokers' loans to a new low point. Holdings of government securities increased by $146,000,000 net during the period, due principally to purchases of bills, while there was a decrease in bonds, offset by an increase in notes, as a result of the Treasury exchange operation.

Currency in circulation has continued its persistent upward trend, and on June 26 stood at $7,780,000,000 — a new high point for all time. This was $818,000,000 higher than one year ago, exceeds the March 1933 peak of $7,538,000,000 and contrasts with $4,669,000,000 (including gold coin) in 1929, when business was around its record level.

Money in circulation, however, has long since lost its traditional value as a barometer or measure of business activity. This is due both to the prevailing large excess of bank reserves, with the resultant practice of banks to allow surplus cash to accumulate in vault rather than being returned to the Reserve Banks for credit, and to the known hoarding — both here and abroad — of U. S. paper currency. These factors, neither of which is related directly to business activity, cause a somewhat misleading growth in the amount of currency officially reported as "in circulation".

Further Restrictions in Foreign Exchange

Last month brought a further restriction of foreign exchange operations in New York. Following surrender of Paris, the French franc ceased temporarily to be quoted, but despite the Italian entrance into the war, the lira continued at 5.05 cents, though with very little

activity. Hence, with Dutch and Belgian currencies suspended in May, Norwegian and Danish in April, Polish, Czech and German earlier in the war, and the entire Mediterranean area now virtually closed to commerce, the Baltic countries under Russian domination, and trading in Spanish pesetas closely restricted, the dealings in European currencies here became limited almost entirely to the pound sterling, Swiss franc and the Swedish krone. Quotations on the latter improved somewhat toward the end of June, presumably on the rumors of peace negotiations between Germany and Great Britain, while greater strength was also shown by the Swiss franc. In May, when the danger of German invasion into Switzerland became acute, francs weakened considerably and trading in future contracts was suspended.

The elimination of Amsterdam and Brussels as trading centers has left New York as the leading market for the free pound sterling, with Switzerland and Shanghai as lesser markets. Even in New York, trading in free sterling became progressively lighter, both because of the curtailment of the supply of free pounds and because of restriction upon their use. Early in May, at the time of the invasion of the Low Countries the free pound sterling weakened, declining from around \$3.50 to \$3.00 with an accompanying accumulation of a considerable short interest. When early in June the British authorities decided to tighten further the exchange restrictions, hurried covering by shorts in a greatly narrowed market led to wide gyrations between the \$3.50 and \$4.00 levels. The latter quotation presumably reflected peace rumors combined with further contraction of the supply of free pound exchange.

The measures taken in June by the British Treasury to further restrict the free market for sterling call for a temporary suspension of sales of sterling securities by non-residents, and for the payment for all exports from the United Kingdom to the United States and Switzerland either in dollars and Swiss francs, or in sterling obtained at the official exchange rate. Thus the most important sources and uses of free pounds are to be eliminated. The announced intention of the British authorities is to extend gradually the system of payment agreements — already concluded with a number of foreign countries and in the process of negotiation with nearly a dozen others — under which international transactions will be settled through a clearing account at the official sterling rate.

New High in Foreign Balances Here

Latest available figures of the U. S. Treasury on international capital movements reveal a new high record of \$3,052,000,000 in foreign short term banking funds reached here at the end of March, 1940. As will be seen from the table below, the influx of new funds to this country, particularly from the Netherlands, Switzerland and the Far East during the first seven months of the war, has more than offset the liquidation of British, French, Canadian and Latin American deposits. The reduction in British dollar balances here amounted to \$233,000,000 during the period, but the rate of decline slowed down considerably as compared with earlier war months, and in March amounted to only \$15,000,000. The French dollar funds, in contrast with the British, declined only about \$25,000,000 between August and March. In the case of Italy, practically all of the indicated increase took place in March.

U. S. Dollar Balances of Foreign Countries

(In Millions of Dollars)

	End of Aug. 1939	End of Mar. 1940	Change
United Kingdom	594	361	—233
Canada	356	250	—106
France	316	291	— 25
Netherlands	159	200	+ 41
Switzerland	283	432	+149
Germany	11	8	— 3
Italy	11	69	+ 58
Other Europe	431	619	+188
Latin America	390	365	— 25
Asia	284	402	+118
All other	70	55	— 15
Total	2,905	3,052	+147

The trend of transactions in foreign-owned American negotiable securities was somewhat similar to the movement of cash balances, although the total of such securities, estimated at \$2,815,000,000 by the Federal Reserve Board at the outset of the war, was reduced somewhat on balance during the first seven months of the war. The British holdings of negotiable stocks and bonds, put at \$735,000,000 by the Board as of the end of August, were reduced, according to U. S. Treasury figures, by \$142,000,000 between August and March, the sale slowing in more recent months. The French actually purchased American securities on balance, but the largest gain took place in the Dutch and Swiss holdings of American securities which increased by \$10,000,000 and \$55,000,000, respectively, in the first seven war months.

The Treasury figures for March also give some indication as to the extent of foreign dollar balances and securities of invaded countries which are now "frozen" by American executive decrees, all transfers from them having been prohibited except as specifically approved by the U. S. Treasury. As at the end of March the foreign dollar balances now involved through such decrees aggregated about \$772,000,000 while the total of negotiable securities involved must have exceeded \$700,000,000, on the basis of Federal Reserve figures at the outbreak of the war and subsequent Treasury reports.

South America's Trade Losses

Brief reference has already been made to losses of export trade which the South American countries may expect as a result of the closing of the Continental European markets. These losses may affect the United States in several ways. They may cause pressure to dispose of commodities which formerly went to the Continent, and thus have a depressing influence upon markets. They will diminish ability to buy United States goods, since South America normally pays for part of her purchases here out of proceeds of her sales to Europe. Even if the Continental markets should be reopened in time to prevent critical difficulties, the terms upon which trade would be resumed, the nature of economic relations between South America and Europe, and the resulting position of this country, are all uncertain. The comments made on the first page of this Letter describe the reasons for concern.

In the confusion various proposals are being advanced as to measures which the United States should take, but it is perhaps too early to comment upon them in view of their half-formed character and the speed with which events are still moving.

Trade is Two-Way

Whatever considerations have to be taken into account, the fundamental principle of trade should be borne in mind. The United States cannot be expected to acquire and hold a larger share of South American trade unless it also makes larger purchases of South American goods and services. If credits are granted their soundness must depend upon observance of this principle, for credits in the end can be repaid only by goods and services.

But although the principle is easy to state, the task of applying it is complex and difficult. A high proportion of South American products are agricultural and compete with United States products, and in some of these we have a surplus problem ourselves. There has been progress in recent years in increasing trade through search for new products in South America, and through exploration of the possibility of producing other articles which the United States now draws from more remote places. The considerable increase in United States imports of Brazilian vegetable fats and oils is an illustration, although the totals do not bulk large in the aggregate trade. Raising imports of new products to a major volume is necessarily slow. South America also produces commodities which are on the "strategic" and "critical" lists, as defined by the Army and Navy Munitions Board; and the defense program includes purchase of such commodities to create reserves above current needs.

The other approach to the problem is to determine what South American products, although competitive with American production, can be admitted in larger quantities, without disrupting domestic production to an extent that would offset the general benefits. The decision is one for the Government to make, weighing one point against another; but the people who will influence the decision should understand that lasting and sound improvement in this country's trade with South America depends upon recognition of its two-way character.

Situation in South American Commodities

The most acute effect of the closing of the Continental European markets is upon Argentine corn. Argentina is the world's greatest corn exporter; she normally sells 80 per cent of her crop abroad, and 60 per cent to the area now shut off. Moreover, she has a bumper crop this year estimated at 419,000,000 bushels, the third largest on record. The Government has extended a loan of 15¢ a bushel to help keep corn on the farms, but pressure for marketing has been so great that small quantities were recently sold for delivery on our Pacific Coast over our 25¢ tariff. These offers were met by sales of government-owned corn by our Department of Agriculture at competitive prices. The recent action of our Government in subsidizing the export of 25,000,000 bushels of corn to Great Britain naturally aggravated Argentina's problem.

The Argentine wheat situation can offer no particular difficulty until the new crop is harvested next Winter, as the carryover at the beginning of the crop year, this August 1, may be only about 50,000,000 bushels, smallest in twenty-five years. Argentina's last crop was subnormal and the Grain Board has pursued a vigorous liquidation policy. If Continental markets are still shut off next Winter the wheat surplus in exporting countries will be huge. Canada alone, if present crop prospects materialize, will have over 500,000,000 bushels for export in 1940-41.

Argentina exported nearly 40 per cent of her hides to the Continent in 1939. Exports during the first four months of 1940 were 10 per cent below the previous year in volume, but 28 per cent higher in value. British tanners have been heavy buyers and United States purchases have been well above average. Supplies of both Argentine and Uruguayan wool are abnormally low. Argentina started the season with low stocks, and exports have been well maintained, in part because the United States has been buying more of its wool from South America since the British Government took over the Australian and New Zealand clips.

Argentina is the world's most important beef exporting country, but only about 15 per cent normally goes to Continental Europe. In 1939 Great Britain took 77 per cent of the total

meat exports. During the first four months of this year shipments were substantially larger both in volume and value than in 1939, and a recent press report states that Great Britain has made additional purchases which will make up for lost Italian and French trade.

Copper, Coffee, Cotton

Chile's copper industry has been affected by loss of the French market. France has been taking copper at the rate of 25,000 tons monthly, chiefly from Chile and the Belgian Congo. British purchases in some degree may make up for this loss, inasmuch as Great Britain's copper supply has been reduced by loss of access to Belgian refineries which formerly refined some of the African production. Apart from what Great Britain takes, however, Japan and Russia are the only normally large markets left for copper produced outside the United States and the British Empire.

The outlets for Brazilian and Colombian coffee of course have been substantially reduced. During the 1938-39 crop year Brazil exported 6,386,000 bags, or almost 40 per cent of her coffee exports, to Europe. During the first eleven months of the current season (July 1 to May 31) her shipments to Europe were reduced by 941,000 bags; and a blockade of France will affect a market which took 1,531,000 bags in 1938-39. This year's Brazilian crop is officially estimated at 20,850,000 bags, roughly 1,000,000 below last year. The Brazilian coffee surplus is of course chronic. She destroyed by burning 4,643,000 bags last season, and since destruction began in 1931 the total amount destroyed has reached 70,000,000 bags.

Colombia, producing a higher quality coffee, shipped a smaller percentage to Europe, 18½ per cent or 758,000 bags in 1938-39. In the first eleven months of the current season these exports were only 172,000 bags. The Colombian Government last April began to pay an export subsidy of ¾¢ per pound.

Brazil's cotton exports have been adversely affected by the war and by the American subsidy program. Exports during the first eight months of the current season declined to 531,000 bales from 771,000 in the same period a year earlier. Markets in Europe which have taken 34 per cent of her cotton exports this season are now shut off, leaving Great Britain and Japan as the two chief outlets, with most hopes concentrated on the latter.

Argentina is by far the largest producer of flaxseed in the world and exports practically her entire crop. About two-thirds of her exports in 1938 went to the Netherlands, France and Belgium. The crop harvested last December was the smallest since 1922, and present stocks are not abnormal. After Europe the United States is the largest buyer of Argentine flaxseed and is taking less than usual, as our own 1939 crop was 20,330,000 bushels, largest in nine years. With average yields our 1940 crop on the acreage planted would approximate 23,000,000 bushels.

Europe's Food Supplies

The converse of surplus commodities in the Western Hemisphere is of course shortage on the Continent of Europe. It is possible that Germany moved to force a military decision this Summer partly because of the increasing need to break through the Allied blockade, or to conclude the war, before food shortage at home became too serious. Meanwhile, however, the food situation has been worsened because the countries overrun do not feed themselves and are now cut off from overseas supplies; and everyone knowing the Continent's food requirements views the possibility of an acute shortage, assuming that the blockade continues, with the most profound concern.

Germany herself accumulated large food reserves prior to the war, but these supplies, particularly of oils and fats, doubtless have been diminishing rapidly. It also appears that German crops of small grains this year are below normal, owing to the hard Winter, and that the potato crop, an important food both for people and livestock, is poor. Moreover, Winter grain crops in the Danubian countries were sharply reduced by the unfavorable weather, and supplies for export are abnormally small. The Roumanian wheat crop alone is estimated at 45 per cent below last year.

The situation in Germany, however, is only part of the story. Germany is considerably more self-sufficient in foodstuffs, counting her access to Southeastern Europe, than the countries she has conquered. Denmark is a great producer and exporter of animal, dairy and poultry products, but depends upon imports for at least one-half of the feed necessary to keep her livestock industries in production. She has now been shut off from Argentine corn and vegetable oilcake from overseas; and press reports have already told of the beginnings of liquidation of livestock, which is the country's productive asset. The situation in the Netherlands is similar. The country normally has a surplus of dairy products, animal fats and vegetables, but depends upon imports of animal feeds, oilseeds and bread grains.

Poland, which normally has a surplus of potatoes, rye and animal fats, was not only overrun at the time of harvest but much of the crops was destroyed. It must be assumed that some destruction of growing crops occurred in the Low Countries and Northern France. Norway, from which reports of severe rationing are already coming, is normally dependent upon overseas food supplies for nearly 60 per cent of her requirements of the most important

staples, and Belgium, which has an intensive agriculture but is densely populated, imports about 50 per cent of her needs. France is nearly self-sufficient in grains, but she too requires large amounts of other imported foodstuffs, drawing chiefly upon her own colonies. The entrance of Italy into the war, which resulted in the closing of the Mediterranean to trade, has further aggravated the food situation in the countries still neutral. Switzerland, for example, is cut off from imports of bread grains and other products upon which she is greatly dependent.

The following table published in February, 1939, by the German Institute of Business Research of Berlin gives figures showing the degree by which the various countries of the world fall short of supplying their own human food requirements. Figures below 100 represent the degree of dependence on imports, while those above 100 show an export surplus.

Self-Sufficiency in Foodstuffs in Important Countries
(In Per Cent)

Countries Controlled by Central Powers	
Germany (Old Territory)	83
Austria	75
Czechoslovakia	100
Poland	105
Norway	43
Denmark	103
Netherlands	67
Belgium	51
France	83
Italy	95
Other Countries on the Continent	
Finland	78
Sweden	91
Portugal	94
Spain	99
Switzerland	47
Greece	80
Jugoslavia	106
Roumania	110
Bulgaria	109
Hungary	121
Latvia	106
Lithuania	110
Estonia	102
British Empire	
Great Britain	25
Irish Free State	75
British India	100
New Zealand	173
Australia	214
Canada	192
Other Countries	
United States	91
Chile	93
Brazil	96
Argentina	264
Soviet Russia	101
Japan	95
China	100

These figures of course refer only to the food requirements of the people. Naturally they misrepresent the situation in a country like Denmark, which can maintain its food production only by importing enormous quantities of livestock feed.

Bread Grains, Fats and Oils

The area affected by the blockade includes a population of some 300,000,000 people. In a normal year its production of wheat and rye would fall 150,000,000 bushels short of requirements. According to the latest Broomhall estimates the net deficit of the importing countries in the 1940 crop year will reach 200,000,000 bushels of wheat alone, and the Danubian States can supply little to fill the gap. The supply of animal feeds is similarly reduced. Normally, the Continent absorbs approximately one-half of the feed grains entering international trade, or around 100,000,000 bushels of barley and oats and 250,000,000 bushels of corn. Except as part of this deficit may be covered by imports from the Danubian countries or from Russia, slaughter of livestock on the Continent will be required.

The most serious situation, probably, is in fats and oils. The Continent normally imports nearly 2,000,000 tons of vegetable oils, either as oil or the oil content of oilseeds imports. At the outbreak of the war Germany was importing about 40 per cent of her fats and oils requirements, and the blockade eliminated over 90 per cent of these imports. Without normal rations of oilcake for livestock the supply of milk and meat in Germany is necessarily reduced, and the shortage of fats must be acute. In 1936 Germany manufactured about 400,000 tons of margarine out of total Continental production of 1,100,000. This compares with the butter output of about 450,000 tons in Germany and 180,000 tons in Denmark. France likewise is greatly dependent upon foreign supplies of vegetable oils; they are her most important sources of fats, and she produces practically none at home. Italy is less deficient, due to her large production of olive oil. These countries will of course have some access to Spanish olive oil production. Whether they can also reach African sources of supply depends upon developments not now clear.

THE NATIONAL CITY BANK OF NEW YORK

The National City Bank of New York

Head Office* · 55 WALL STREET · *New York

Condensed Statement of Condition as of June 30, 1940

(In Dollars)

INCLUDING DOMESTIC AND FOREIGN BRANCHES

ASSETS

Cash and Due from Banks and Bankers		**$1,247,074,280**
Gold Abroad or in Transit		**1,206,709**
United States Government Obligations (Direct or Fully Guaranteed)		**725,503,880**
Obligations of Other Federal Agencies		**35,502,834**
State and Municipal Securities		**138,287,768**
Other Securities		**57,935,928**
Loans, Discounts and Bankers' Acceptances		**498,731,602**
Real Estate Loans and Securities		**7,903,247**
Customers' Liability for Acceptances		**7,733,095**
Stock in Federal Reserve Bank		**3,900,000**
Ownership of International Banking Corporation (Including Paris Office)		**8,000,000**
Bank Premises		**41,877,294**
Other Real Estate		**469,244**
Other Assets		**654,709**
Total		**$2,774,780,590**

LIABILITIES

Deposits		**$2,591,963,229**
Liability on Acceptances and Bills	**$29,233,121**	
Less: Own Acceptances in Portfolio	**16,243,792**	**12,989,329**
Items in Transit with Branches		**9,736,833**
Reserves for:		
Unearned Discount and Other Unearned Income		**3,973,539**
Interest, Taxes, Other Accrued Expenses, etc.		**6,698,290**
Dividend		**3,100,000**
Capital	**$77,500,000**	
Surplus	**53,000,000**	
Undivided Profits	**15,819,370**	**146,319,370**
Total		**$2,774,780,590**

Figures of Foreign Branches are as of June 25, 1940.
(Brussels as of April 25)

$69,444,689 of United States Government Obligations and $17,676,551 of other assets are deposited to secure $59,823,769 of Public and Trust Deposits and for other purposes required by law.

(Member Federal Deposit Insurance Corporation)

City Bank Farmers Trust Company

Head Office* · 22 WILLIAM STREET · *New York

Condensed Statement of Condition as of June 30, 1940

(In Dollars)

ASSETS

Cash and Due from Banks	**$107,464,613**
United States Government Obligations (Direct or Fully Guaranteed)	**27,815,420**
Obligations of Other Federal Agencies	**2,504,907**
State and Municipal Securities	**6,255,334**
Other Securities	**1,734,035**
Loans and Advances	**7,511,663**
Real Estate Loans and Securities	**5,645,759**
Stock in Federal Reserve Bank	**600,000**
Bank Premises	**3,958,256**
Other Real Estate	**400,346**
Other Assets	**1,579,793**
Total	**$165,470,126**

LIABILITIES

Deposits	**$138,874,832**
Reserves	**1,665,998**
Capital	**10,000,000**
Surplus	**10,000,000**
Undivided Profits	**4,929,296**
Total	**$165,470,126**

$1,520,000 of United States Government Obligations are deposited with public authorities for purposes required by law.

(Member Federal Deposit Insurance Corporation)